

**2000 Audit Committee Conference  
Presentation**

**Cathy E. Minehan  
President and Chief Executive Officer  
Federal Reserve Bank of Boston**

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It is a pleasure to be with all of you this morning. My job today is to talk with you about the work of the Financial Services Policy Committee, fondly known as the FSPC. I plan to cover what the Committee's relationship is to efforts underway at your Reserve Banks, and what I believe your role as Audit Committee Chairs and General Auditors should be in assessing the risks associated with FSPC endeavors. I look forward to an engaging question-and-answer session after my remarks.

The FSPC, and the overall financial services management structure, reflects decisions made by the Reserve Banks in 1994 aimed at strengthening their national organization structure for financial services activities. The Banks believed that such activities needed to be organized to respond more quickly and creatively to the changing needs of a banking industry whose participants increasingly operated in multiple Reserve Districts. There also was a need to better coordinate and integrate Reserve Bank financial service plans and activities, and for better accountability for managing the growing complement of shared System-level activities. Finally, in my view, a more consolidated

financial service management structure was a necessary adjunct to the consolidation of mainframe data processing services that occurred at about the same time, and the related consolidation of major payment service software and operations.

As you will note in your handout, the Committee itself is made up of three presidents and two first vice presidents. The inclusion of a majority of Reserve Bank CEOs on the Committee was specifically intended to bring more strategic focus and Bank leadership to financial services management, and keep these centralized efforts firmly accountable to the highest levels of System management. You should also note that the FSPC reports directly to the Conference of Presidents—clearly the Banks have strong ownership over all FSPC endeavors.

Within the FSPC structure are several important groups:

- the Product Offices, each headed by a part-time FVP product director and a full-time senior officer;
- the FSPC staff, with duties related to budgets, reporting, legal and public relations matters; and

- the Financial Services Operations Council or FISOC, which acts as a senior council to coordinate tactical plans and operations across product offices.

One issue that is often raised relative to the FSPC reflects concerns about the increased level of consolidation and centralization. In short—does the FSPC structure render a Reserve Bank powerless to innovate or to develop its own plans for financial services? This is an understandable concern, and one which Reserve Bank presidents have wrestled. It has been our conclusion—as reflected in the COP statement in your handout—that consolidation should be pursued when it is clearly the best and most efficient way to organize, but that Reserve Bank innovation and vitality are absolutely vital as well. Thus, we in the FSPC have focused on strategic direction-setting; on managing the major Systemwide efforts; on streamlining and making more effective budgeting, reporting, and project approval processes; and on national management of systems and customer relations. We rely on individual Reserve Banks to engage in local innovation, to provide operational advice by product specialty,

and, most importantly, to carry out the plans and implement the projects of the management structure.

This balancing of central control and regional activity is nowhere more evident than in the interplay between the FSPC strategic plan, and the several major initiatives underway in 2000-2001. You all have a copy of the strategic plan in your handouts. When you have a chance to look it over, you will note it outlines five major strategic goals: to work collaboratively with the private sector to move our country's paper-based retail payment system to electronics; to leverage our use of technology to reengineer current financial service and support systems to make them more efficient; to enhance existing products and services, and develop new products that are secure and easy to access; to develop the next generation of financial service systems; and finally, to align staffing, management processes and performance measures to ensure our goals are met. We believe that if we are successful in meeting these goals over the next year five years Reserve Banks will better understand the markets they serve and the U.S.

payment system will be very different: more electronic, more efficient, and with a wider array of easily accessed services.

During 2000-01, significant progress has been and will be made toward achieving these goals, and responsibility for that progress lies squarely in the hands of both the Product Offices and the Reserve Banks. Your next handout provides information on four key FSPC initiatives: check modernization, improved electronic access, conversion of Ginnie Mae to book entry, and a variety of consolidation and innovation efforts for the Treasury. You'll note we've highlighted the clear ways in which each of these efforts supports our longer-term goals, but even more important is the cross Reserve Bank effort and leadership needed in each.

For the massive Check effort, Atlanta and Cleveland lead the product office, senior officers from Minneapolis, Boston, San Francisco and Dallas lead key aspects, and Richmond's FRAS organization provides central data processing support. San Francisco takes the lead on access projects, but Philadelphia, Atlanta, New York, and FRAS provide vital software development

and support. New York bears the brunt of the Ginnie Mae conversion, but every Bank will offer this new product. The Treasury has consolidated various operations in Boston, Minneapolis, Dallas, New York, and St. Louis, and is challenging us all to step up to new payment technologies. Finally, where would we be without the customer and market input so necessary in assessing progress in these important areas—here Chicago takes the lead with the Business Development office.

By now, I think you see my point. In many ways it would not be possible for the Banks to address the tidal wave of operational, technological and industry change facing us as we aim at our strategic goals without centralized management. By the same token, it would be impossible for the centralized management of the FSPC and Product offices to carry out their responsibilities without local Reserve Bank innovation, support, and active participation. Together we can make the changes envisioned when the FSPC was organized.

No change comes without risks and that takes me to your involvement as General Auditors and chairs of Reserve Bank

Board Audit Committees. I don't have to tell the audit community broadly speaking anything about the need for risk identification and management; clearly that is increasingly the major function of internal audit. As FSPC chair, I ask that all Product offices clearly defines the sources of risk in each of our endeavors, and what risk mitigation strategies can be followed. Similarly, I expect that the various audit areas involved at local Reserve Banks will include in their audit attentions projects under the control of the local Reserve Bank. In addition, audit departments in Banks with major responsibilities for shared services—Richmond for FRAS as an example, or Boston for the integrated accounting system—have a duty to all Reserve Banks to ensure these areas are routinely reviewed. Moreover, this duty includes assuming a mantle of leadership, in my view. Attitudes regarding how financial, operational and reputational risk is balanced evolve over time as technology creates opportunities to provide more cost effective, and arguably well controlled services to customers. We at the FSPC would hope that the audit community will embrace this evolution.

Some examples here might make this point more clearly. One of the Cash/Fiscal Product offices objectives for 2000 is a fundamental review of the System's Custody Control Principles and Standards. In the Cash area, business owners have been discussing the balance between risk of financial loss and improved efficiency. We are now experimenting with single control in the processing of one dollar notes, at first during lunches and breaks, and then for an entire shift. Given the sophistication of our camera systems, and the low denominations involved this might be a better way to manage risk. Similarly, in the area of web-based products, the security needed to allow customers to access information, as opposed to making live payments, will be different, and separate assessments of the balance between risk and exposure need to be made by both those involved in these efforts and the audit community. Happily I am confident that this rational and evolving attitude toward risk assessment seems to be well entrenched among Reserve Bank internal audit staff.

I'd also like to take a moment to point out to all of you a change that will be made in Reserve Bank cost accounting starting with the 2001 budget process that should contribute both to a better understanding of Reserve Bank risk in the environment of greater centralization, and better management of it. Under the process used up to this time, many if not most costs incurred by Reserve Banks in the provision of shared services—like Product offices—or major projects—like check modernization—would have been shared by all Banks. Thus what would appear on a Reserve Bank's expenses would be a figure reflecting the net amount of costs distributed out for efforts done locally, and received in for efforts done elsewhere. The cost of Boston's management of all Reserve Bank general ledger accounting systems, for example, could not be easily identified on published reports, except in shared project budget data approved once a year. Under the new process, Boston's budget and cost reports will show those costs fully – and the impact of System project efforts on local management should be both more

transparent to directors and auditors, and easier to evaluate. This I regard as an important step forward.

The pace of industry, operational and technological change surrounding all of us is breathtaking. We have established the FSPC structure to aid the Reserve Banks in being more strategic, better able to deal with change, more market oriented, and simply quicker on our feet. I hesitate to say we've been totally successful, but I think we're getting there. Significant challenges remain, however. First, what is in essence matrix management of efforts across Reserve Banks with many officers and staff having both project and local responsibilities can be complex, particularly when issues of general organizational governance and performance assessment and reward are involved. Rewards, incentive payments, promotions and other aspects of employee assessment increasingly need to be fair, both within a Reserve Bank, and across Bank organizations. Large projects like check modernization make this even more apparent, and more challenging as well.

Second, the pace of change itself is a daunting challenge. Developing processes and systems for all twelve Banks presents the risk increasingly that we'll be implementing a new technology just about the time it becomes obsolete. For any of you who know about our Fedline for Windows effort—that seems to me to be a case in point. And there is also real risk in believing vendor hype – some Reserve Bank operations and risk sensitivities are unique and any easy off-the-shelf technological approach to access or security should, I think, be viewed with skepticism.

Finally, we are constantly challenged by limited resources. We need technologically and analytically sophisticated human resources and they are in short supply and expensive. Each of the major efforts facing us is also capital intensive. We must make headway on our strategic goals, but at the same time meet our individual and collective cost-revenue targets. That puts the premium on reducing the cost of ongoing operations as much as possible—and creates ever more difficult budget and pricing efforts for Reserve Banks. In addition, we have to find ways to monitor and control local and collective efforts not only in

comparison to plan and budget but to expected outcome as well. We cannot afford to get to the end of our many complex endeavors only to realize that the gains we expected—the progress toward our ultimate strategic objectives—have not been realized.

These are challenges for FSPC management, but they are challenges for you as well. As your Audit Committees meet monthly, I ask you to ensure you address both local responsibilities and System endeavors housed at your Bank. I ask you to ensure that audit coverage is adequate and that your board and Bank management is aware of any concerns and issues you might have. And most of all, for all you Reserve Bank audit committee chairmen, ask the tough questions. I can tell you that more than once in Boston I have been brought up short by a question at an Audit Committee meeting or a full board meeting – often a simple question that has caused me to rethink something I had gotten a little too close to. Your input and expertise is vital if the Banks, individually and collectively, are to continue that difficult move forward. Thank you.